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Testimony Supporting

S.B. No. 815, An Act Concerning A Moratorium on Business Tax Credits

Testimony of Dr. Douglas Hall
To the Committee on Finance, Revenue, and Bonding
February 9, 2009

Senator Daily, Representative Staples, and distinguished Members of the Finance, Revenue, and Bonding Committee,

I am testifying today on behalf of Connecticut Voices for Children, a statewide research and advocacy organization that works to promote the well-being of Connecticut's children, youth, and families. As child advocates, we have a particular responsibility to ensure that Connecticut's revenue system is sound. Currently, tax expenditures – including business tax credits – take a bite estimated at almost $5 billion/year out of Connecticut's revenues (see Figure 1 below). According to the Office of Fiscal Analysis' *2008 Tax Expenditure Report*, $556 million was projected to be lost to tax expenditures through the corporation income tax in FY09 (see Figure 2, on page 2). We support the objective of this bill, which protects revenues that support critical needs in other areas of the state budget, while providing a two-year pause in business tax credits that should be used to ensure that appropriate systems of transparency and accountability are in place. We strongly believe that expenditures made on the tax side should be subject to annual scrutiny just as are appropriated expenditures.

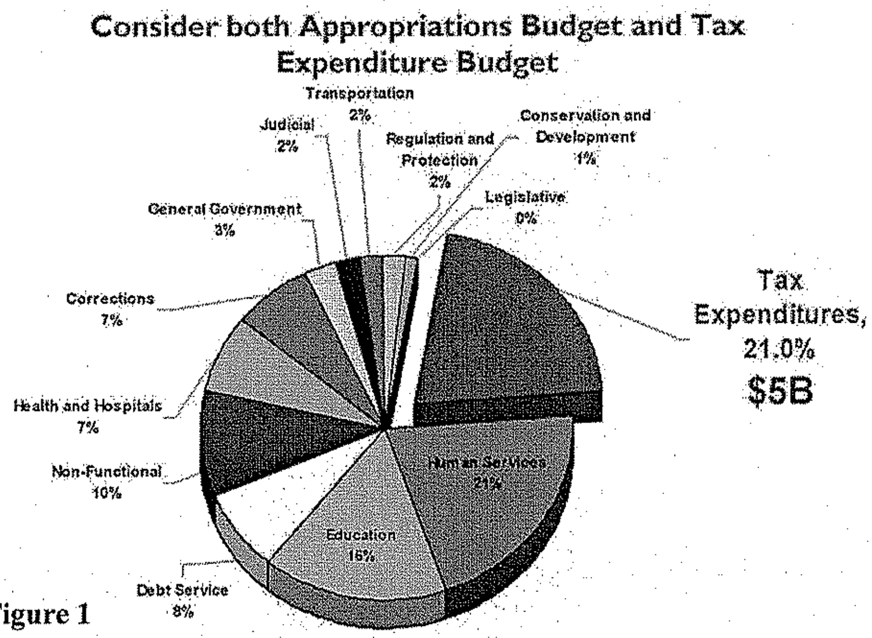

Figure 1

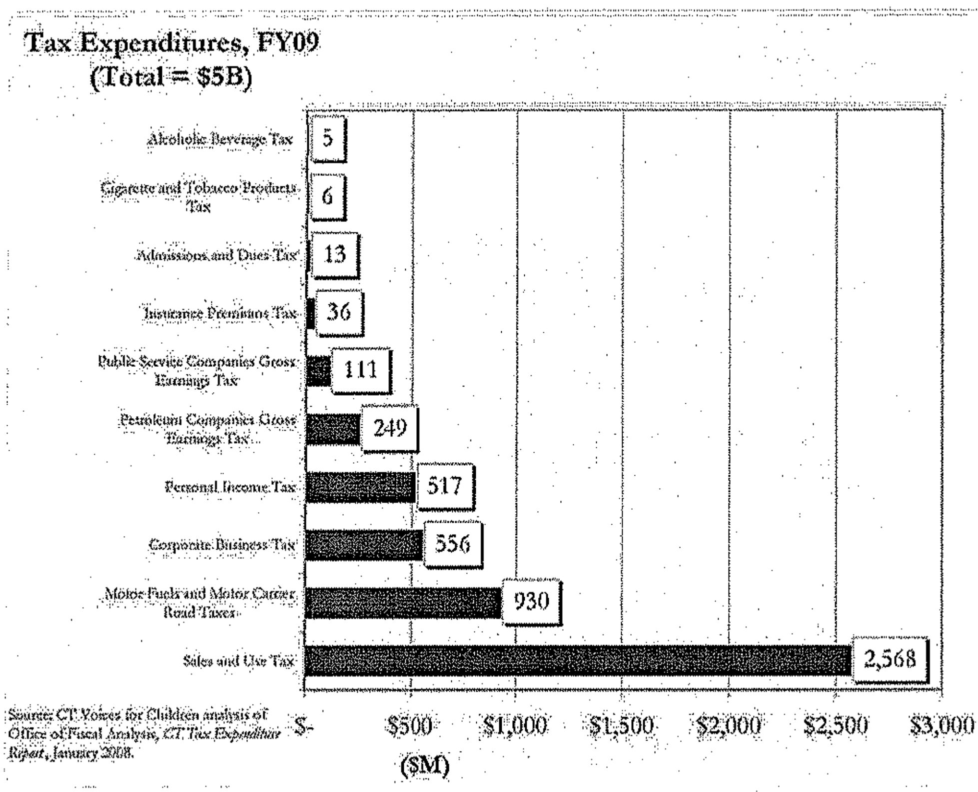

Figure 2

Figure 3 below shows the dramatic decline in corporation business tax revenues as a share of General Fund revenues over the past two decades. While the initial decline can be accounted for by the more significant role played by the personal income tax after its adoption in 1991, the ongoing erosion of revenues from the corporate business tax is due in part to the dramatic growth in corporate tax expenditures.

In the absence of such routine oversight by the General Assembly, Connecticut's business tax credits risk becoming blank checks for economic development. While such an

Corporate Tax Revenue as a Share of GF Tax Revenue (FY 1990-2008)

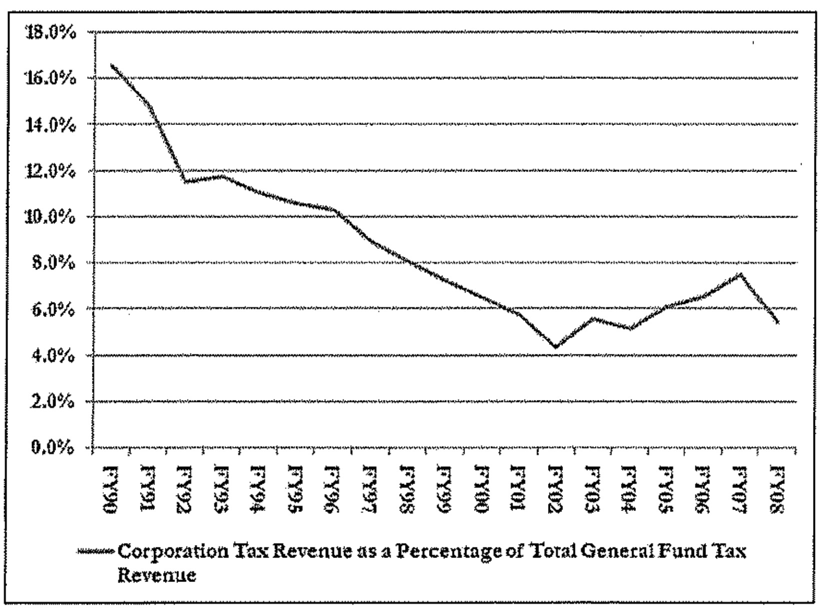

Figure 3
Sources: Historical budget data derived from Office of Fiscal Analysis, *Connecticut Revenue and Budget Facts*, February 27, 2006, pp.6, 38; Governor's Midterm Budget Adjustments (FY2006-2007); Governor's Biennial Budget (FY2008 - FY2009); Governor's Budget Adjustments (FY 2009 Midterm).

approach is highly questionable as economic policy, as fiscal policy it is clearly flawed, and contributes significantly to the deficit situation in which Connecticut currently finds itself.[1]

Connecticut's revenue loss from corporation business tax credits has increased *113-fold* since 1987. In 1987, Connecticut had a total of nine credits against the corporation business tax. In that year, 289 corporate tax returns claimed a total of $2.7 million in tax credits. By 2003, the number of credits had increased to twenty-three, and 7,266 returns claimed a total of $93.1 million.[2] OFA now projects a $305.6 million revenue loss in FY 09 from corporate business tax credits.[3] This is 113 times greater than the revenue loss from corporate business tax credits 20 years ago and nearly 6 times greater than the total FY 08 budget of Connecticut's Department of Economic and Community Development (including its bond and carry-forward funds).

Tax credits favor certain industries and companies over others, violating a core principle of a high quality revenue system – neutrality.[4] The Legislative Program Review and Investigation Committee's 2006 study of Connecticut's tax system reported that a "very small number of filers claim the overwhelming majority of credits" against the corporation business tax. Specifically, in 2001, 13% of all companies filing a corporate income tax return (i.e., those corporations filing a combined return) received 77% of the total value of all credits claimed.[5] Further, only thirteen corporations claimed five or more credits and the total value of the credits they claimed was about one-quarter the total corporate tax revenue lost through tax credits.[6] In fact, in 2003 *only one* of Connecticut's largest 100 companies paid more than $1 million in corporation business tax, after tax credits.[7]

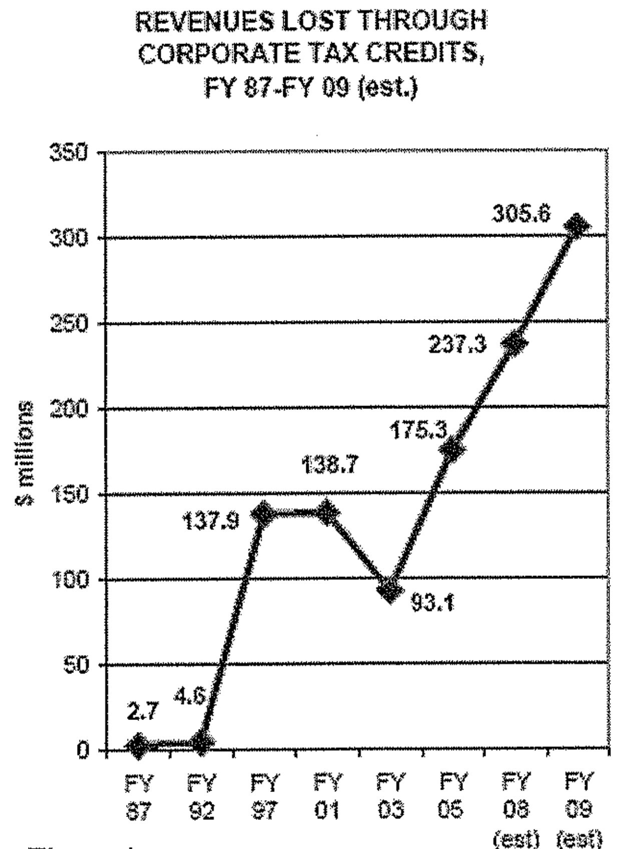

Figure 4

Source: OFA, *FY 08-FY 12 General Fund and Transportation Fund Budget Projections and Fiscal Information* (November 15, 2007), pp. 28-29, cited in S. Geballe, *Business Tax Credits: The Blank Check in Connecticut's Economic Development Portfolio*, (Connecticut Voices for Children, 2008).
Note the FY09 projected number in this figure ($305.6) differs from the number in Figure 2 above ($556.2) because this larger number encompasses both corporate tax credits ($305.6) and deductions and exemptions ($250.6m).

Relatively few of Connecticut's business tax credits put a ceiling on the total amount of credits that can be claimed in a given year. As a result, the state's total revenue loss through tax credits is open-ended. About one-third of Connecticut's business tax credits are capped. That is, the amount of credits granted cannot exceed a specified amount each year (e.g., no more than $15 million in historic structures tax credits can be granted each year).

Six tax credits are available to corporations even if they have *no* Connecticut business tax liability to offset, in that they are transferable to others with tax liability or can be sold back

to the state. Three of these six transferable credits were enacted in support of the film industry – the film industry, film infrastructure, and digital animation credits. For example, the new "film industry" tax credit – an uncapped credit equal to a full *30%* of Connecticut pre-production, production, and post production expenses for the wide range of productions covered by this credit (e.g., films, commercials, videogames, music videos, digital and other productions) – is transferable. That is, a company eligible for the credit because it has qualified production expenses, but has *no* Connecticut corporate tax liability, can *sell* the credit to a Connecticut corporation or insurance company that *has* tax liability to offset. Indeed, these credits are available to partnerships and limited liability companies that are *not* subject to the corporation business tax (only a $250/year business entity tax); they can *sell* the credits to companies that have tax liability to offset. There need be *no* economic relationship between the business taxpayer that eventually uses the credit and the economic activity that purportedly is being encouraged by the tax credit. Even OPM Secretary Robert Genuario expressed grave concerns about the proposal to create such a credit:

> "One reason the proposal is so costly is that the bill appears to extend corporate tax credits to non-corporate entities. This would be a major change in tax policy and would set the precedent to open up all our corporation credits to any business or individual. We must not forget that in 1993 Connecticut passed the Limited Liability Company law permitting the formation of such entities. One of the primary benefits of such an entity is its ability to pass through income to the partner's individual tax return which is taxed at a lower rate. These lower taxed firms would now generate a corporation tax credit which they could sell to other parties. As this proposal does not have any caps on the maximum amount a firm can avail itself of, the state could be in the position of just a handful of companies benefiting handsomely, instead of using our limited resources to nurture a numerous number of entities to build a self-sustaining cluster of regional expertise and capabilities."[8]

A Point of Clarification regarding SB S.B. No. 815, An Act Concerning A Moratorium on Business Tax Credits

While Connecticut Voices for Children supports SB 815, we do have one concern about the potential implementation of the bill. In practice, there may be an important distinction between the ***awarding*** of tax credits (on which this bill places a moratorium), and the ***claiming of tax credits*** (on which this bill is currently silent). We urge this committee to insert language to clarify that the moratorium extends to both the awarding, and claiming, of corporate tax credits.

We thank the committee for its time, and for considering this testimony.

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[1] For greater detail, see Shelley Geballe, Business Tax Credits: The Blank Check in Connecticut's Economic Development Portfolio?, (Connecticut Voices for Children, 2008).

[2] OFA, *Connecticut Revenue and Budget Data* (February 27, 2006). Note: the plateau in the growth of credits claimed around FY 01 resulted in part from the fact that S corporations no longer were subject to the corporation business tax, so could not claim tax credits against it. The decline in the economy, coupled with a change in the law preventing tax credits from extinguishing a company's tax liability (see note 14 below) contributed to the dip in credits claimed around FY 03.

[3] OFA, *FY 08-FY 12 General Fund and Transportation Fund Budget Projections and Fiscal Information* (November 15, 2007), p. 27.

[4] The National Conference of State Legislatures has defined nine key principles of a high quality revenue system. One is that a tax system should be "neutral," i.e., it should not be "used to influence economic decisions on spending or investments." Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), pp. 9, 27, 201.

[5] While the Committee found that corporate income tax liability was reduced by about 23% through tax credits (at the time of the study), it was the 7,255 companies that filed a combined return that achieved the greatest reduction in their

taxes through credits; their average tax before credits was $29,428 and after credits $14,801, a 50% reduction on average. The 5,325 companies that filed under the capital base method reduced their taxes through tax credits, on average, from $6,335 to $3,493 (a 45% reduction). By comparison, companies that filed under the net income method cut their taxes through tax credits by just 12% (from $14,208 to $12,511, on average). Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), pp. 99, 202.

[6] Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), p. 202.

[7] Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), p. 202. In 2003, eighteen of the Connecticut's 100 largest companies were not subject to the corporation business tax and paid the $250/year "business entity" tax. Another 18 of the state's 100 largest companies paid the $250 minimum corporation business tax. In short, more than 1/3 of Connecticut's 100 largest companies paid just $250 each in business tax in 2003.

[8] Testimony on March 14, 2006 to the Commerce Committee.